REPORT ON THE OEB COST ASSESSMENT MODEL DEVELOPMENT AND CONSULTATION PROCESS

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INTRODUCTION

Model Development and Consultation Process

The OEB undertook a re-examination of its Cost Assessment Model in the context of the impact of recent legislative changes on the OEB and changes in the current mix of market participants. It was also important to consider how activities associated with each type of participant drive the OEB's costs and how the Cost Assessment charges impact customers.

Pursuant to a competitive procurement process, the OEB commissioned Navigant Consulting Ltd. ("Navigant") to undertake a study and recommend a cost assessment model, which was published on November 1, 2004.

All natural gas and electricity market participants were then invited to participate in stakeholder consultations by providing feedback on the the Navigant report. In addition to informal feedback, the OEB received sixteen written responses.

After careful consideration of the Navigant report and all stakeholder feedback, the OEB finalized its new Cost Assessment Model for 2005-06.

The OEB will continue to study two aspects of the model during 2005-06: whether the Independent Electricity System Operator, the Ontario Power Authority, and Designated Facilities should be included as Classes; and whether there is a more appropriate allocator within the Electricity Distribution Class.

The Navigant Report, stakeholder feedback, and the OEB's final Cost Assessment model are all posted on the OEB's website: *http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_costassess.htm*.

Nature of this Document

As expected, stakeholders' feedback provided a wide range of perspectives. This document provides an explanation of the OEB approach for issues where the final Cost Assessment Model differs from that proposed in the Navigant report as well as for issues where the OEB approach is consistent with the Navigant report, but differs from stakeholder feedback.

A complete description of the OEB's new Cost Assessment Model is posted on the OEB website.

Key Differences Between the OEB Model and the Model Proposed by Navigant

The major areas where the OEB model differs from that proposed by Navigant are:

1. Refinement of the guiding principles.
2. Classes of market participants to be included in the general assessment, and the implications with respect to the principal of cost causality.
3. The OEB's operating reserve.

Stakeholder Input Under Consideration, But Not Currently Reflected in the OEB Model

An issue for which a change was considered but not yet implemented was the basis of intra-class allocation for electricity distributors.

1. REFINEMENT OF GUIDING PRINCIPLES

Figure 14 of the Navigant Report summarized guiding principles used for developing the proposed model. As OEB considered stakeholder input and had further discussion, these principles were further refined. There were trade-offs in consideration of these principles, which were intended to assist in focusing discussion of the issues. The OEB believes that the new Cost Assessment Model reflects an appropriate balance of the following guiding principles:

1. Ultimately, customers pay all regulatory costs. The Cost Assessment Model should be: clear and direct, fair, transparent, cost effective and provide incentive to use regulatory services efficiently.
2. The Cost Assessment Model should ensure that costs incurred in regulating the customer groups are ultimately recovered from those customer groups.
3. The Cost Assessment Model should allow the OEB to be financially self-sufficient and avoid the need to borrow funds.
4. All licensed market participants should contribute to the OEB's funding.
5. The Cost Assessment Model should strive for stable and predictable assessments and/or fees for market participants.
6. The OEB should seek to mitigate year-over-year volatility in the apportionment of its funding requirements to each Class of market participant.
7. Allocation within a given Class of market participants should balance fairness, accuracy and predictability where possible.

The most significant refinement from the Navigant principles was the shift from considering cost causality as it relates to participant classes, to considering cost causality and impact in terms of the final customer. This issue is further addressed in the next section.

2. CLASSES OF MARKET PARTICIPANTS TO BE INCLUDED IN THE GENERAL ASSESSMENT, AND THE IMPLICATIONS WITH RESPECT TO THE PRINCIPAL OF COST CAUSALITY

Most stakeholder feedback addressed the issue of which categories of market participants should be included in the general assessment (i.e. Classes).

Cost causality was a key principal underpinning the model's development. Initially cost causality was considered in terms of the how the Board's interaction with market participant groups drives Board costs. However, input (mainly from competitive market participants) presented a compelling argument for cost causality being analyzed from the perspective of impact on the ultimate customer.

The OEB recognized a need to establish criteria for inclusion in the general assessment process. After considering the Navigant report and stakeholder feedback, the OEB decided to include market participants in the general assessment process if:

- their rates are regulated by the OEB; and
- their key activities are subject to regular and routine supervision by the OEB; and
- their contribution would not lead to inequitable results for customers.

Market Participants not included in the General Assessment

The Independent Electricity System Operator and the Ontario Power Authority

Under the preceding criteria, the Ontario Power Authority (OPA) and the Independent Electricity System Operator (IESO) would be included in the cost assessment.

The OPA has been established and is preparing to take on its responsibilities and the role of the IESO as it relates to the OPA is being clarified. These

changes will have significant impact on the level and type of activity and interaction with the Board. The Board will closely observe how this part of the sector evolves so that it can ensure the most appropriate approach going forward and make recommendations to the Government to adjust this transitional arrangement as required, commencing in 2006-07.

Competitive Market Participants

The OEB was convinced that inclusion of gas marketers and electricity retailers in general cost assessment would lead to inequity in costs ultimately borne by customers who are served by default supply (whether gas or electricity) on the one hand, compared to customers who are served by competitive supply on the other. This is because distributors will pass through their assessment costs to all distribution customers regardless of whether these customers' commodity is supplied by the distributor or a retailer/marketer.

In other words, distributor assessments do not unbundle regulatory costs relating to distribution from regulatory costs relating to commodity. Thus all distribution customers pay for both. In light of this, it is the view of the Board that it is inappropriate for customers of retailers/marketers to pay these costs and in addition pay regulatory costs related to competitive supply. The Board believes that the recovery of costs through approved rates will more accurately apportion ratepayer costs.

Also, retailers and marketers offer consumers long-term, fixed-price contracts. In most cases, these participants are not able to recover newly imposed costs from existing customers and therefore either new customers or shareholders, or both, would have to bear these costs.

Electricity Wholesalers and Electricity Generators

Electricity Wholesalers and Electricity Generators do not generally have regular activity with the OEB and the added complexity and administrative cost of introducing a separate Class was not considered cost-effective.

Certain rate regulated electricity generation facilities are prescribed by regulation pursuant to s.78.1 of the *OEB Act, 1998* to be "designated facilities". The Board does not currently regulate the prices of the output of such facilities. However, in anticipation of activity related to the regulation of designated generation, the Board will monitor how the Board's work related to designated facilities evolves and the cost of this activity to determine whether it should recommend that designated facilities be included as a Class beginning in 2006-07.

Related Issues

Impact of Compliance Issues on the General Assessment

Much of the OEB cost uniquely associated with retailers/marketers relates to compliance and enforcement. While the OEB views compliance as an important and proactive function of the Board, it is a relatively small portion of the annual

budget. The added complexity and administrative cost of introducing a separate Class for retailers/marketers to which only compliance and enforcement costs would be apportioned, was not considered to be warranted.

Retailers/marketers will pay the annual registration fee. Those fees reduce the amount recovered through the general assessment. In addition, in terms of costs caused by individual participants, OEB considered that it can and will collect the costs of proceedings (i.e., outside of the general cost assessment process) that directly relate to marketers/retailers. This will provide an appropriate incentive as market participants who consistently attract significant penalties (and related costs) will not be able to pass these costs on to customers without losing competitive advantage.

Annual Fees

A number of stakeholders advocated that all market participants contribute to the OEB's funding. The OEB agrees that this would provide some incentive for efficient use of the Board's services. The Board also believes that this should take the simplest form possible.

Given the limited interaction between the Board and wholesalers and generators, and the issues related to the inclusion/exclusion of competitive market participants, the Board believes the simplest way of ensuring that all market participants contribute to the OEB's funding is through an annual license fee for each license held by market participants.

Allocation of Indirect Costs Across Classes

Most of the stakeholder feedback in this area related to whether the indirect costs (such as technology infrastructure, leases, and other administrative costs) should be allocated to non-rate-regulated types of participants. Given that only rate-regulated entities are included in the General Assessment the issue narrows to the basis for allocation of indirect costs. The direct time-sheet approach was selected as it was a simple, cost-effective approach to allocating costs that is consistent with cost causality.

3. THE OEB'S OPERATING RESERVE

Some stakeholders expressed concern that access to an operating reserve would reduce the OEB's incentive to manage in a cost-effective manner. Others expressed concern with respect to the size of the annual reserve and accumulated reserve cap percentages. Stakeholders also advocated that when accumulated unspent revenues (including reserve funds) exceeded the cap, the excess reserve funds be returned to the funding contributors.

The OEB carefully considered stakeholder input and undertook further analysis of reserve funds in other similar organizations, including regulatory bodies. Accordingly, the OEB has refined its approach to establishing and maintaining the operating reserve.

The reserve will be funded from:

- surpluses from under spending during the year (i.e., when actual amounts are less than the approved OEB Budget, which was the basis for the annual funding requirement amount used for the general assessment);
- surpluses from penalties, which are not budgeted; and
- a charge for 15% of the annual funding requirement, phased in through equal installments over the first three years, beginning with the 2005-06 fiscal year.

In future periods, the accumulated operating reserve may be adjusted to equal 15% of the then current annual funding requirement.

The accumulated operating reserve will not exceed 15% of the annual funding requirement. If the accumulated operating reserve exceeds the 15% reserve cap, accumulated surpluses from under spending and the operating reserve assessment will be used to reduce payments under future assessments.

On the other hand, surpluses from penalties would not be used to reduce payments under the general assessment.

STAKEHOLDER INPUT UNDER CONSIDERATION, BUT NOT CURRENTLY REFLECTED IN THE OEB MODEL

In the OEB model, apportionment within the Electricity Distribution Class will be based on *distribution revenues*.

Some stakeholders reasoned that the OEB's work associated with a given electricity distributor is more related to the distributor's number of customers than to the revenue collected from those same customers. In addition, areas requiring a higher investment in assets (for example, to distribute in rural areas, or to distribute underground) have higher distribution revenues. Consequently they would be assigned a greater proportion of costs if distribution revenues were used.

The OEB's initial analysis to assess which allocator (number of customers, distribution revenues and kilowatt hours) most closely reflects the level of Board activity has not yet identified an ideal allocator or mix of allocators.

OEB considered that the change in the basis for allocating indirect cost (to being proportionate to direct costs) has significant impact on all classes, including electricity distributors. A change in the basis for apportionment from distribution revenues would have an additional, significant impact to most distributors. Therefore, no change in the basis for intra-class allocation for electricity distributors will be made at this time.

The Board will further analyze and consult with stakeholders over the next year as to the most appropriate allocator for the Electricity Distributor Class, as well as for the other Classes. Any resulting changes to the basis of intra-class apportionment will be made for the 2006-07 assessment.